

GAO

Accounting and Financial
Management Division



149456

GAO
Accounting and Financial
Management Division
Office of the Inspector General
U.S. General Accounting Office
Washington, D.C. 20548

149456

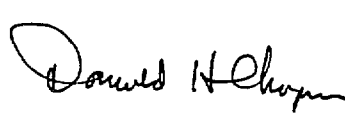
Preface

This guide provides a framework for evaluating and testing the effectiveness of internal controls that have been established in various sensitive payment areas.

Sensitive payment areas encompass a wide range of activities including executive compensation, travel, official entertainment funds, unvouchered expenditures, consulting services, speaking honoraria and gifts, and executive perquisites. Although the dollar amounts involved are usually not large enough to materially affect the fair presentation of the financial statements, the public disclosure of improper payments may result in significant criticism of the entity and, by association, the entity's auditor.

Accordingly, evaluation and testing of controls over sensitive payment areas, as described in this guide, should be conducted as part of a financial statement audit. For financial-related and performance audits, the auditor should follow this guide for any sensitive payment areas that are considered relevant to the assignment objectives.

This guide replaces the Guide for Review of Sensitive Payments, Technical Guideline 8.1.2, November 1988.



Donald H. Chapin
Assistant Comptroller
General, Accounting
and Financial
Management Division



Werner Grosshans
Assistant Comptroller
General
Office of Policy

Revised
May 1993

Contents

Preface	1
Introduction	4
General Approach	7
Appendixes	
Appendix I: Specific Sensitive Payment Areas	14
Appendix II: Reporting on a Separate Audit of Controls Over Sensitive Payments	19

Abbreviations

FAM	GAO Financial Audit Manual
GAGAS	generally accepted government auditing standards
GAO	General Accounting Office
IG	inspector general
OGC	Office of General Counsel

Introduction

Because senior government executives are vested with the public trust and hold positions with a high degree of decision-making authority, they are subject to the scrutiny and criticism of the public and the media. Such scrutiny is particularly intense in the event of any impropriety or conflict of interest, real or perceived, regardless of how much money, if any, is involved. Yet, within this sensitive environment, senior government executives must still conduct the government's business effectively. Senior government executives include officers and directors of government corporations and senior executive service (SES)-level officials in executive branch departments and agencies.

Sensitive payment areas encompass a wide range of executive functions including executive compensation, travel, official entertainment funds, unvouchered expenditures, consulting services, speaking honoraria and gifts, and executive perquisites. Sensitive payment issues are addressed in various laws, regulations, and policies and procedures manuals. These include Office of Personnel Management (OPM) compensation and personnel documents, government travel regulations, and Comptroller General opinions.

Sensitive payments have long been a subject of concern because senior executives may have the opportunity to bypass internal controls in these areas. Although the dollar amounts involved are usually not large enough to materially affect the fair presentation of financial statements, public disclosure of improper payments may result in significant criticism of the entity and, by association, the entity's auditor.

Purpose

The purpose of this guide is to provide an approach for evaluating and testing the effectiveness of controls over sensitive payment areas. These controls should

encompass the activities of senior executive service employees as well as other employees responsible for key decisions in government entities (herein referred to as senior executives). The procedures in this guide are not intended to address compliance with all applicable laws or regulations or all related entity policies and are not sufficient to form the basis for an opinion on the effectiveness of these controls.

The sensitive payment areas discussed herein generally are considered to pose a high level of risk because they are susceptible to problems such as noncompliance with related laws and regulations or abuse.

During the course of an audit, other sensitive areas may come to the auditor's attention or may be identified with the assistance of the Office of General Counsel (OGC). In these cases, the auditor may consider following the general approach discussed in the remainder of this guide.

Applicability

For financial statement audits, all of the sensitive payment areas listed are considered relevant to the assignment objectives. The auditor should perform the procedures discussed in this guide for each sensitive payment area.

For financial-related and performance audits, the auditor must determine which, if any, of the sensitive payment areas are relevant to the assignment objectives. To the extent that an area is considered to be relevant, the auditor should perform the procedures discussed in this guide. Depending on the assignment objectives, the auditor may elect to perform additional tests of controls or to test sensitive payments directly. For example, procedures could be performed that provide sufficient evidence

to support an opinion on the controls. Such procedures are beyond the scope of this guide.

Assignment objectives should be defined as precisely as possible to preclude unnecessary work while meeting the purpose of the audit. GAO's General Policies/Procedures Manual contains detailed discussions on establishing assignment objectives (chapter 6.2) and supporting the Congress (chapter 3.1).

General Approach

For each sensitive payment area that is considered relevant to the assignment objectives, the following procedures should be performed and documented:

- Consider the impact of the control environment.
- Understand internal control systems.
- Identify specific controls.
- Test specific controls expected to be effective.
- Assess control effectiveness and perform additional procedures, if necessary.
- Report findings.

The purpose of these procedures is to identify control weaknesses that might fail to prevent or detect noncompliance or abuse in the relevant sensitive payment areas. In performing these procedures, the extent of work should be commensurate with the auditor's judgment of the extent of the risk of noncompliance or abuse in each area.

Prior to beginning these specific procedures, the auditor should review any inspector general (IG), internal audit, Financial Managers' Financial Integrity Act (FMFIA), or GAO reports issued in relation to the entity or its senior executives for the relevant sensitive payment areas. Also, the auditor should understand the nature of any related audits in progress.

Consider the Impact of the Control Environment

The control environment includes management's philosophy and operating style, the entity's organizational structure, the effectiveness of the inspector general, and management's ability to promptly identify and react to changing conditions. The control environment sets the "tone at the top" of an entity. Additional guidance on assessing the control environment is included in the GAO Financial Audit Manual (FAM) sections 260 and 295 B.

The auditor should consider whether weaknesses in the control environment could impair the effectiveness of specific control policies and procedures in the relevant sensitive payment areas, particularly for senior executives. For example, a poor control environment may allow management overrides of specific internal controls that otherwise would prevent or detect noncompliance or abuse.

Understand Internal Control Systems

Generally, controls over sensitive payment areas should prevent or detect the misuse of public funds and noncompliance with related laws and regulations.

Through discussions with entity management, the auditor should obtain an understanding of the entity's overall process for establishing controls in each sensitive payment area that is relevant to the assignment objectives. For example, the auditor might consider the entity's process for

- identifying and documenting laws and regulations applicable to the entity in the relevant sensitive payment areas;
- monitoring changes in applicable laws and regulations and responding on a timely basis;
- establishing policies and procedures for preventing abuse and complying with specific laws and regulations, as well as clearly documenting and communicating these policies and procedures to appropriate personnel;
- assuring that an appropriate number of competent individuals at appropriate levels within the entity monitor the entity's and employees' compliance with the established policies and procedures (including monitoring the actions of senior executives); and
- investigating, resolving, communicating, and reporting any noncompliance with the established policies and procedures.

General Approach

The auditor should also understand how transactions are recorded in the accounting and budget systems for areas such as compensation, travel, official entertainment funds, unvouchered expenditures, contract and consulting services, and executive perquisites. These subjects are described further in FAM 320.

To increase efficiency, the auditor should consider the need for this information when planning and performing other audit work in these areas.

Identify Specific Controls

The auditor should identify the specific controls that the entity has in place to achieve the control objectives listed under each relevant sensitive payment area in appendix I. These control objectives are not intended to address compliance with all applicable laws or regulations or all related entity policies. The auditor may supplement the listing in appendix I as considered necessary to meet any other assignment objectives.

The auditor should identify the entity's specific controls even when it appears that the effectiveness of such controls is impaired due to weaknesses in the control environment. The purpose of identifying such controls is to determine whether any additional weaknesses exist that should be communicated to entity management.

Test Specific Controls Expected to Be Effective

The auditor should test only the controls that are expected to be effective in achieving the related control objectives through a combination of observation, inquiry, and inspection.

Observation. The auditor observes entity personnel performing control techniques in the normal course of their duties.

Inquiry. The auditor makes either written or oral inquiries of entity personnel involved in the application of specific control techniques to determine what they do or how they perform a specific control technique.

Inspection. The auditor examines documents and records for evidence (such as the existence of initials, signatures, or other indications) that a control technique was applied to those documents and records.

When choosing the types of tests, the auditor should consider the nature of the control, the timing of and period covered by the control tests, and relative efficiencies. Usually, a combination of these tests is needed to provide the auditor with sufficient evidence about the effectiveness of the control. For example, the auditor may observe the control in operation during the audit period and use inquiry and inspection to determine that the control was in operation during the entire audit period. Because the auditor is not providing any assurance on these controls, control testing should be limited to the extent necessary to determine that the control has been placed in operation. Accordingly, statistical selection of items for control testing generally is not necessary. Additional information on such control tests is in FAM 350.

Assess Control Effectiveness and Perform Additional Procedures, if Necessary

The auditor should determine whether the entity achieved the control objectives for each relevant sensitive payment area based on the results of the procedures performed.

For each control objective that the entity achieves through the use of effective controls, no additional procedures are necessary.

For control objectives that are not achieved, the auditor should perform additional procedures to determine the effects of these control weaknesses and to identify whether actual abuse or noncompliance is likely to have occurred. Control objectives may not be achieved because relevant controls (1) do not exist or (2) do not operate effectively as a result of poor design, inappropriate implementation, or control environment weaknesses. Also, the auditor should consider whether the control weaknesses affect the achievement of the assignment objectives.

Type and Extent of Additional Procedures

The type and extent of additional procedures to perform are matters of the auditor's judgment. When making these decisions, the auditor should consider the type and the potential severity of the control weakness and the significance of the weakness to the assignment objectives. The tests should be focused in the areas where control weaknesses have been identified that might result in noncompliance or abuse. Based on the auditor's judgment, the additional procedures may be part of the current assignment, a separate assignment, or referred to a third party, such as the entity's IG.

If the assignment is a congressional request, the auditor should discuss with the requester the need to modify the scope and timing of the work in view of

General Approach

additional procedures and investigation of possible illegal acts.

Evaluating the Results of Additional Procedures

If possible noncompliance (illegal acts) or abuses are identified, the auditor should consult with OGC and the Office of Special Investigations.

Determining whether abuse has occurred is difficult because there generally are no clear criteria for making these judgments. Abuse is distinct from illegal acts (noncompliance). When abuse occurs, no law or regulation is violated. Rather, abuse occurs when the conduct of a government organization, program, activity, or function falls short of societal expectations of prudent behavior. To recognize abuse, the auditor should be sensitive to these expectations and should understand the purposes of the law and any related regulations. OGC can assist the auditor in understanding the purpose of a law or regulation and in evaluating possible instances of abuse or noncompliance. Additional guidance on identifying abuse is provided in Assessing Compliance with Applicable Laws and Regulations (GAO/OP-4.1.2).

Generally accepted government auditing standards (GAGAS) provide guidance for notifying senior entity officials or the appropriate oversight body if illegal acts, abuse, or indications of such acts are discovered by the auditor.

Report Findings

If control weaknesses, abuse, or noncompliance are identified in sensitive payment areas during an audit, the auditor should report such weaknesses, abuse, or noncompliance as follows:

- Financial statement audit. Report in accordance with FAM 580. The auditor should also consider the

effects, if any, on the report on the financial statements.

- Financial-related or performance audit. Report in accordance with the guidance in the GAO Communications Manual and GAGAS. A suggested report example is provided in appendix II for audits where the sole objective is to evaluate and test controls over sensitive payments.

Based on the procedures described in the guide, the auditor should only report findings, for example, control weaknesses and possible or actual noncompliance. The auditor should not provide any type of positive or negative assurance on internal controls or on any items tested.

If the auditor elected to perform additional procedures sufficient to provide an opinion on the effectiveness of the controls, related reporting guidance may be found in FAM 580.

Specific Sensitive Payment Areas

The following sensitive payment areas are generally considered to be susceptible to abuse or noncompliance with laws and regulations. The auditor should consider whether each area is relevant to the assignment objectives. (All of these areas are considered relevant to a financial statement audit.)

If an area is considered relevant to the assignment objectives, the auditor should identify and test the specific controls used by the entity to achieve the control objectives listed in this appendix for senior executives. Consideration of other controls in these areas is not required; however, the auditor may choose to do so to achieve other assignment objectives.

Compensation

Consider the entity's controls related to employee compensation, including salary, bonuses, and awards. Focus on controls that provide reasonable assurance of the following:

- Bonuses and awards are authorized and approved.
- Salary amounts for senior executives do not exceed the amounts allowed by law.
- Compensation-related expenses are properly classified and reported.

Travel

Consider the entity's controls related to travel expenditures, including those for relocation. Focus on controls that provide reasonable assurance of the following:

- Travel is authorized and approved.
- Travel vouchers are authorized and approved. Include controls providing assurance as to the
 - existence of supporting documentation;
 - correctness of amounts, calculations, and footings;
 - and

- consideration of the propriety of the expenses, including consideration of whether the purpose of the travel that is indicated on the travel authorization and voucher is commensurate with the executive's position and duties for official travel.
- Travel expenses are properly classified and reported.
- Travel advances are authorized and approved.
- Outstanding travel advances are promptly collected or applied to future trips.

Note: While considering travel vouchers, be alert for potential improprieties resulting from the following:

- frequent trips to one location on official travel, particularly visits that may be to the employee's hometown, the location of past schools, or to relatives or friends;
- coupling of official business and personal vacation travel;
- type of accommodations, for example, privately chartered aircraft, hotel suites, first class travel; and
- travel expenses paid by others.

Official Entertainment Funds

Official entertainment funds exist in some government entities for costs associated with entertaining visiting dignitaries and state functions. The amount of these funds generally is limited by law.

Consider the entity's controls related to official entertainment funds. Focus on controls that provide reasonable assurance of the following:

- Entertainment fund expenses are authorized and approved. Include controls providing assurance as to the
 - existence of supporting documentation;
 - correctness of amounts, calculations, and footings; and

- consideration of the propriety of the purpose of the expenses.
 - Amount of entertainment fund expenses does not exceed the amount authorized by law.
 - Entertainment fund expenses are properly classified and reported.
-

Unvouchered Expenditures

Funds exist in some government entities that may be used at the discretion of the chief executive/entity head to further the entity's mission, but do not require the same level of documentation as a typical transaction. Expenditures of these funds are referred to as unvouchered expenditures. The amount of these funds is limited by law. GAO's access to audit such funds may also be limited by law. (OGC should be consulted if a question of access arises.)

Consider the entity's controls related to unvouchered expenditures. Focus on controls that provide reasonable assurance of the following:

- Unvouchered expenditures are authorized.
 - Unvouchered expenditures are approved.
 - Unvouchered expenditures do not exceed the amount authorized by law.
 - Unvouchered expenditures are for appropriate and legal purposes.
 - Unvouchered expenditures are properly classified and reported.
-

Contract and Consulting Services

Consider the entity's controls related to expenditures for contract and consulting services. Focus on controls that provide reasonable assurance of the following:

- Contract and consulting services are authorized.

- Payments for contract and consulting services are approved. Include controls providing assurance as to the
 - existence of supporting documentation, including evidence of receipt of goods or services;
 - correctness of amounts, calculations, and footings; and
 - approval of the payment by appropriate officials, including consideration of whether the goods were purchased for official business.
- Contract and consulting services expenditures are properly classified and reported.
- Access to contractor's proprietary information contained in current contract and consulting procurement documents is appropriately restricted.

Note: Controls in this area should address potential conflict-of-interest problems such as

- direct or sole source selection by senior executives;
- ownership interest in companies that the entity does business with, as evidenced by financial disclosure forms or other substantiated data;
- senior executive approval of contractor invoices for payment; and
- repeated use of the same contractors.

Speaking Honoraria and Gifts

Speaking honoraria and gifts to government employees are restricted by law. Consider the entity's controls related to speaking honoraria and gifts. Focus on controls that provide assurance of the following:

- Employees are informed as to the restrictions on the receipt of honoraria and gifts and related procedures for remittance of certain proceeds to Treasury.

-
- Illegal receipts of honoraria and gifts would be detected, such as through review of annual financial disclosure forms.
 - Proceeds are remitted to Treasury, when appropriate.

Executive Perquisites

Consider the entity's controls related to executive perquisites such as parking, limousine service, dining facilities, office space and furnishings, and other government owned or furnished facilities. Focus on controls that provide reasonable assurance that executive perquisites provided by the entity comply with relevant laws and regulations.

Ethics and Conflicts-of- Interest Rules

Consider the entity's controls related to ethics and conflicts-of-interest rules. Focus on controls that provide reasonable assurance of the following:

- Employees are informed as to what constitutes an ethics violation or a conflict of interest.
- Written financial disclosures are obtained from all employees who are required to file.
- All forms are reviewed for potential conflicts of interest.
- Any potential conflicts of interest are identified and resolved.

Reporting on a Separate Audit of Controls Over Sensitive Payments

General

This suggested report may be used when an auditor evaluates and tests internal controls over specific sensitive payment areas as a separate financial-related audit. This work might include procedures in addition to those described in the accompanying guide, depending on the assignment objectives. For example, the additional procedures could include examination of a limited sample of transactions in each sensitive payment area to determine whether the transactions were proper.

The following example report would be appropriate when

- all sensitive payment areas are evaluated and tested,
- additional procedures involving the selection of a limited sample of transactions for testing were performed, and
- control weaknesses were noted.

The report should be modified as appropriate to reflect the extent of work performed by the auditor and the auditor's actual findings and conclusions.

The auditor may choose to perform procedures that extend beyond those described in this guide for the purpose of providing assurance or an opinion on the effectiveness of controls in the sensitive payment areas. Guidance on the scope of work to be performed and reporting may be found in FAM 580 and applicable standards.

Appendix II
Reporting on a Separate Audit of
Controls Over Sensitive Payments

Sample Report

REPORT ON INTERNAL CONTROLS OVER SENSITIVE PAYMENTS

We have evaluated internal controls of ABC Entity and examined a limited sample of transactions for the period from XXX to XXX in the following sensitive payment areas related to senior executives and other key management officials:

- compensation,
- travel,
- official entertainment funds,
- unvouchered expenditures,
- contract and consulting services,
- speaking honoraria and gifts,
- executive perquisites, and
- ethics and conflicts-of-interest rules.

Our procedures were not sufficient to provide an opinion on internal controls related to sensitive payments, nor would they disclose all weaknesses. However, we noted certain weaknesses in internal controls that we consider to be significant deficiencies in the design or operation of the internal controls that, in our judgment, could adversely affect the organization's ability to meet the internal control objectives related to the sensitive payment areas listed above.

[Describe the weaknesses.]

The management of ABC Entity is responsible for establishing and maintaining internal controls. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. Because of inherent limitations in any system of internal control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the controls to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

We conducted our work in accordance with generally accepted government auditing standards.

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, if necessary. Orders for 100 or more copies mailed to a single address are discounted 25 percent.

Order by mail

U.S. GOVERNMENT PRINTING OFFICE
705 N. ZEEB RD.
SPRINGFIELD, MD 21151-0001

U.S. GOVERNMENT PRINTING OFFICE (GPO)
WASHINGTON, DC 20540-0001

U.S. GOVERNMENT PRINTING OFFICE
1635 R STREET, N.W.
WASHINGTON, DC 20036-5001

United States
General Accounting Office
Washington, D.C. 20548

First-Class Mail
Postage & Fees Paid
GAO
Permit No. G1

Official Business
Penalty for Private Use \$300